SUMMARY of COOPERATIVE CASES

FARMER COOPERATIVE SERVICE
U. S. DEPARTMENT OF AGRICULTURE
WASHINGTON, D. C.

SUMMARY NO. 66 DECEMBER 1955

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The comments on cases reviewed herein represent the personal opinion of the author and not necessarily the official views of the Department of Agriculture.

CAPITAL RETAINS OUT OF SALES PROCEEDS BY MARKETING COOPERATIVE HELD NOT TAXABLE TO PATRON UNTIL REDEEMED IN CASH

(Moe v. Earle, ____ F. 2d____ (C.A. 9th))

The U. S. Court of Appeals (Ninth Circuit) affirmed a district court decision in Moe v. Earle without a reasoned opinion on October 28, 1955. The lower court had held in an oral opinion that retains for capital purposes, made by a marketing cooperative from the proceeds derived from the handling and marketing of apples, were not taxable to the patron in the year retained or in the year certificates were issued to evidence such retains but only when redeemed in cash.

Moe is a member of Apple Growers Association, an Oregon corporation organized under its general corporation laws rather than its cooperative association statute. He has been a party to a standard marketing contract with the association continuously since 1929. The contract provided for payment of advances to growers and payment of net proceeds within 30 days after the closing of the pool. The bylaws of the association contain provisions for deductions from amounts paid growers to be credited to a Building and Equipment Fund. Deductions were made in 1930, 1931, 1935, 1936, and 1937. Growers received pool closing statements which indicated amounts received by the co-op from the sale of produce, the expenses, deductions, and net credit to be paid to them.

Until 1940, the co-op's bylaws contained no requirement that retain certificates be issued to evidence the Building and Equipment Fund deductions. In that year the Building and Equipment Fund was made part of a revolving fund, and a provision made for the issuance of certificates. In 1942, the association completed computation of the amounts due each grower and issued the certificates. These documents were entitled "Certificates of Contribution to Revolving Capital Fund." They included a statement to the effect that they did not constitute debts of the association, were null and void if the membership of the recipient was cancelled, and were not negotiable. Their redemption was at the sole discretion of the association's board of directors, and they bore no interest. Each year after 1942, the association issued a similar certificate to growers representing prior year's deductions. In 1949, the association revolved out the amount of the 1930 and 1931 "contributions." Moe, who had filed no returns during the 1930's and had not included any part of the certificates in gross income for 1942 or subsequent years, reported the amounts revolved out to him in 1949 in his gross income for that year. Additional sums were revolved out to him in 1951, and these too were reported in his gross income for that year. Thereafter he filed a claim

for a refund of taxes based on the argument that the amounts received in 1949 and 1951 were returns of capital and constituted income only in the 1930's when they were contributed to the association. As to any income in the 1930's, he claimed that the statute of limitations had run.

In the meantime the Commissioner had conducted a field audit of Moe's 1949 return and had added to his gross income the face value of the 1949 contributions certificate, and assessed a deficiency in that amount. This audit was subsequent to the ruling in 1950 that the face amount of retain certificates was includible in gross income. Moe's 1951 return included the amount of that year's certificates. The claim for refund was denied and Moe then sued in the U. S. District Court of Oregon. Judge Solomon gave an oral opinion, in which he concluded that the cash received by Moe in 1949 and 1951 was income then, and held that the amounts deducted in the 1930's were not income then or in 1942 when the certificates were issued. Moe appealed. The summary of his attorney's argument on the appeal was as follows:

> "The taxpayers received full payment of the net sales proceeds of their fruit each year when a part of such proceeds was paid to them in cash and the balance was set off by the cooperative against their obligation to contribute to the cooperative's capital fund. Accordingly any tax on that part of the net proceeds which the taxpayers invested in that manner in the capital of the cooperative accrued in the years, and only in the years, in which those capital investments were made. The 'certificates' issued in 1942 were mere receipts evidencing such prior capital investments by the taxpayers, and could not constitute or represent 1942 taxable income in any amount. The cash received by the taxpayers in 1949 and 1951 in refund of the prior investments in the cooperative's capital was a return of capital and hence not taxable as income during those years."

The Circuit Court merely issued a per curiam opinion which said:

> "This appeal raises complicated questions of income taxation in regard to the withholding of a portion of the proceeds derived from the handling and marketing of apples by a cooperative organization. The appeal is from a judgment of the district court by which the court denied a taxpayer a refund of amounts paid under protest.
>
> "The judgment is affirmed without a reasoned opinion because we adhere to the general principles expressed in our opinion in the case of Caswell's Estate v. C.I.R., 1954, 9 Cir., 211 F. 2d 693, See also C.I.R. v. Carpenter, 1955, 5 Cir., 219 F. 2d 635."

RIGHT TO DISMISS A MANAGER EMPLOYED UNDER SPECIAL CONTRACT FOR A DEFINITE TERM

(United Producers and Consumers Co-operative v. Held, 225 F. 2d 615)

The board of directors of a corporation cannot discharge without cause a manager hired for a definite term under a valid contract without becoming liable for damages, even though its bylaws provide that its manager shall hold office at pleasure of and on terms and conditions fixed by the board of directors. That is the basic holding of the United States Court of Appeals, Ninth Circuit, in this case.

Held was invited and urged to become the manager of United Producers and Consumers Co-operative (hereafter United) and also Southwest Co-operative Wholesale, a wholesale company whose principal customer was United, by Smith, president of both corporations. Held accepted by signing a written contract which specified a three-year term on March 20, 1952, and assumed his duties on April 1, 1952. Smith died suddenly on March 25, 1952. On May 27, 1952, Held was informed by the man who had succeeded Smith that the legality of his contract was questioned and he was notified that his employment contract was terminated June 20, 1952. This court action followed, and Held was given judgment in the lower court for the amount owing him under the three year contract minus "mitigating income" earned during the period of the contract. United appealed.

On appeal it was contended, first, that the fixed term contract was invalid under the bylaws of the cooperatives, both of which provided that the manager ". . . shall hold office at the pleasure of and upon terms and conditions fixed by the Board of Directors." The court, after reviewing the authorities cited by United, concludes that these state an "old" rule which has since been changed. It then cites and discusses Cuppy v. Stollwerck Bros., 1916, 216 N.Y. 591, 111 N.E. 249, 251, and In Re Paramount Public Corporation, 2 Cir., 90 F. 2d 441, 442, 443, as stating the new and preferred rule. 19 C.J.S., Corporation, p. 72, was also cited as stating the new rule. In conclusion, the court said:

> "We do not believe that the bylaws upon which both appellants rely permit them to discharge an officer or employee without cause when he has been hired for a definite period or term without becoming liable for damages. We think that on the evidence the lower court could have found and concluded as he did, that the contract was legally valid and enforceable and that appellants wrongfully terminated the instant contract without justification."

Appellants also argued that the three-year term of the contract was unenforceable because it was beyond the term of the board of directors which made the contract. The court rejected this contention also. It pointed out that "Arizona has neither statute nor case law prohibiting employment contracts which extend beyond the term of office of the existing board of directors." On this point the court concluded:

> "The members of the boards of the appellant corporations were elected for staggered three year terms. The contract made with appellee was for a period of three years. We find no sound reason to repudiate the conclusion that the contract in the case at bar was made for a reasonable time and is therefore valid."

COOPERATIVE AGENT, BY COURSE OF CONDUCT, CAN CREATE SITUATION WHERE COOPERATIVE IS ESTOPPED TO DENY AGENT'S AUTHORITY

(Tifton Production Credit Association v. Burkhalter Chevrolet Co., 89 S.E. 2d 210)

In this case the defendant had purchased an automobile only after the plaintiff's president had by parole agreement released the automobile as security. Plaintiff then brought this action to recover the automobile, the action being in trover and based upon a bill of sale to secure debt given to plaintiff by defendant's transferor. The Court of Appeals held that, under the facts stated, plaintiff would be estopped from enforcing its right under the bill of sale against the defendants, if the following facts were also proven: (1) the president, although plaintiff's bylaws prohibited such releases, had over a considerable length of time, to the knowledge of, but without objection from, the board of directors, followed the practice of making parole releases of personalty covered by bills of sale held by plaintiff, and (2) this was known to the defendant and acted upon by it.

RIGHT OF PRIVATE POWER COMPANIES TO ENJOIN PROGRAM UNDER RURAL ELECTRIFICATION ACT

(Kansas City Power & Light Company v. McKay, 225 F. 2d 924)

Private electric power companies, which have no exclusive franchise to supply electric power, have no capacity to maintain suit to enjoin execution of a Federally supported power program and contracts entered into for the purpose of putting it into effect. So said the United States Court of Appeals, District of Columbia Circuit, in the case cited above.

This suit was brought by electric utility companies operating in Kansas, Missouri, and Arkansas, asking for relief against the Secretaries of the Interior, Agriculture, and the Treasury, and the Administrators of the Southwest Power Administration (SPA) and the Rural Electrification Administration (REA). The court was asked to enjoin them---(1) from lending funds of the United States to SPA or to certain federated power cooperatives for the construction by the latter of electric generating and transmission facilities and for the sale and purchase of electric power to and from them by SPA; and (2) from doing anything in furtherance of an alleged plan by which SPA would in effect construct and acquire control of these generation and transmission facilities. It was also asked to declare that the defendants had no right, power or authority to carry out the alleged plan.

Defendants moved to dismiss the complaint for the reason, among others, that plaintiffs did not have capacity, and did not show any injury or interest entitling them, to maintain the suit. The District Court Judge denied the motion. Thereafter, on trial of the issue of legality of the contracts and lease agreements, he held that the contracts and agreements were valid and authorized under the Rural Electrification Act and the Flood Control Act of 1944, respectively. From the final judgment for the defendants, all the plaintiffs except one appealed. The holding of the appellate court is stated in the opening paragraph. On this main issue the court said, in part:

> "It is indisputable that the essence of plaintiffs' complaint is the competition which they will suffer if the Government's contracts are carried out. They can claim no other interest or injury. The defendants have not undertaken to regulate them in any way. They have not been ordered to abandon any of their activities or to forego the expansion programs planned by them. They have not been subjected to any obligation or duty. Their sole interest and objective is to eliminate the competition which they fear. Controlling decisions of the Supreme Court, dealing with other electric power contracts of the Federal

> Government, establish that an interest of this kind is not sufficient to enable them to sue to enjoin execution of the power contracts and program of the Government. See Alabama Power Co. v. Ickes, 1938, 302 U.S. 464, 58 S. Ct. 300, 82 L. Ed. 374; Duke Power Co. v. Greenwood County, 1938, 302 U.S. 485, 58 S. Ct. 306, 82 L. Ed. 381; Tennessee Electric Power Co. v. T. V. A., 1939, 306 U.S. 118, 59 S. Ct. 366, 83 L. Ed. 543."

The appellants tried to take their case out of the scope of the Alabama Power Co. case, but the court rejected these arguments. The appellants also tried to base their right to bring the action on their alleged status as persons "suffering legal wrong" or "adversely affected or aggrieved" within the meaning of section 10(a) of the Administrative Procedure Act. But the court also rejected this argument. Circuit Judge Prettyman dissented.

RECENT INTERNAL REVENUE SERVICE RULINGS OF INTEREST TO COOPERATIVES

1. The I.R.S. rules on situation where "exempt" cooperative allocates on a patronage basis net margins resulting from C.C.C. business. (Rev. Rul. 55-591; I.R.B. 1955-38, 28)

> "The allocation of income of a farmers' cooperative marketing association resulting from the handling and storage of grain of the Commodity Credit Corporation during the fiscal year ended May 31, 1954, which is distributed on a patronage basis to persons who have done business with the association during any or all of the fiscal years 1949 through 1954, will not affect the exempt status to which the association is otherwise entitled under section 101(12)(A) of the Internal Revenue Code of 1939.
>
> "Amounts allocated with respect to income from the handling and storage of Commodity Credit Corporation grain, if distributed on a patronage basis in the manner indicated in the foregoing paragraph, may be deducted from gross income of the association for the year ended May 31, 1954, provided the distribution is made on or before the 15th day of the ninth month following the close of the year.

"Advice has been requested with respect to the distribution as patronage dividends of net savings which a farmers' cooperative marketing association has for the fiscal year ended May 31, 1954, as the result of handling and storing grain of the Commodity Credit Corporation during such year.

"The instant association is exempt from Federal income tax under the provisions of section 101(12)(A) of the Internal Revenue Code of 1939. It is engaged primarily in the business of storing and marketing grain for members and patrons. Due to severe drought conditions in the territory served by the association there was an unprecedented low production of grain during the fiscal year 1954 and a resultant unprecedented small quantity of grain stored by members and patrons in the association's storage facilities.

"The Commodity Credit Corporation acquired an abnormally heavy surplus of grain during the fiscal year 1954 which had been produced in other vicinities for which it lacked storage space. Such grain was moved into the drought area to utilize the available storage space there. The association furnished some of the needed storage space and was the recipient of emoluments for the handling and storage of this grain during the fiscal year ended May 31, 1954. Comparative figures for the fiscal years 1949 through 1954 show that the number of patrons and the quantity of grain stored by the patrons of the association in the fiscal year 1954 are abnormally low as compared with the prior years.

"The association has allocated and distributed to its patrons who have done business with it during the fiscal year ended May 31, 1954, the net savings resulting from the business done by them during such year. However, the revenue resulting from the handling and storage of grain of the Commodity Credit Corporation during the fiscal year 1954 has been allocated on a patronage basis to its patrons who have done business with it during the fiscal years 1949 through 1954.

"Section 39.101(12)-1(c) of Regulations 118 provides that business done with the United States or any of its agencies shall be disregarded in determining the right to exemption under section 101(12) of the Code.

"Section 39.101(12)-3(d) of Regulations 118 provides that business done with the United States shall constitute income not derived from patronage. This section of the Regulations allows as a deduction from the gross income of an exempt cooperative association amounts allocated during the year to patrons with respect to its income not derived from patronage. However, the section requires, in order that the deduction for allocations with respect to income not derived from patronage may be applicable, that the amount sought to be deducted be allocated on a patronage basis in proportion, insofar as practicable, to the amount of business done by or for patrons during the period to which such income is attributable.

"Based upon the foregoing facts, it is held that the allocations of income resulting from the handling and storage of the grain of the Commodity Credit Corporation during the year ended May 31, 1954, which is distributed on a patronage basis to patrons who have done business with the association during any or all of the fiscal years 1949 through 1954, will not affect the exempt status to which the association is otherwise entitled under section 101(12)(A) of the Code.

"It is further held that the amounts allocated with respect to the income from the handling and storage of Commodity Credit Corporation grain, if distributed on a patronage basis in the manner indicated in the foregoing paragraph, may be deducted from gross income of the association for the year ended May 31, 1954, provided the distribution is made on or before the 15th day of the ninth month following the close of the year."

(This ruling appears to be a published version of the informal ruling quoted in Summary No. 60, p. 9, June 1954.)

2. Fishermen's Purchasing Cooperative is not eligible for exemption under Sec. 521. (Rev. Rul. 55-611; I.R.B. 1955-41, 10)

> "An association which purchases supplies and equipment for its members who are fishermen is not a farmers' purchasing association within the meaning of section 521(b)(1) of the Internal Revenue Code of 1954 and, therefore, is not exempt from Federal income tax under such section.

"Advice has been requested whether an association which purchases supplies and equipment for its members who are fishermen is a farmers' purchasing association within the intendment of section 521(b)(1) of the Internal Revenue Code of 1954.

"The instant organization was incorporated for the purpose of engaging in any activity involving or relating to collecting, catching, taking, planting, producing, buying, receiving, grading, processing, packing, storing, financing, preparing for market, handling, marketing, selling, and/or distributing of aquatic products, or conducive to buying, selling or otherwise handling fishery and marine supplies and equipment; and for the conduct of any activity deemed to be necessary, convenient, proper or expedient for the accomplishment of such purposes on a cooperative basis for the mutual benefit of its members.

"It is contended on behalf of the instant organization that it operates in a manner similar to a farmers' or fruit growers' association or other group of persons, and should be considered a 'like association' as that term is used in section 521 of the Code. In this connection, it is pointed out that under the State laws the term 'agricultural products' includes fish and salt water sea food and that the State law has recognized the instant association as an agricultural association.

"Section 521(b)(1) of the Code relating to exempt farmers' cooperatives reads in part as follows:

> "'* * * The farmers' cooperatives exempt from taxation to the extent provided in subsection (a) are farmers', fruit growers', or like associations organized and operated on a cooperative basis (A) for the purpose of marketing the products of members or other producers, and turning back to them the proceeds of sales, less the necessary marketing expenses, on the basis of either the quantity or the value of the products furnished by them, or (B) for the purpose of purchasing supplies and equipment for the use of members or other persons, and turning over such supplies and equipment to them at actual cost, plus necessary expenses.'

"An association which is not composed of farmers, fruit growers, or persons engaged in similar pursuits is not exempt under section 521 of the Code unless it could be considered a 'like association' within the intendment of that section. The provisions of any State laws are not controlling in determining status for Federal income tax purposes. See Munro L. Lyeth v. Hoey, 305 U.S. 188, Ct. D. 1370, C.B. 1938-2, 208.

"An issue similar to that here presented was before the court in Sunset Scavenger Company, Incorporated v. Commissioner, 84 Fed. (2d) 453, Ct. D. 1190, C.B. 1937-1, 202 at 204. In that case the court stated:

> "'We believe, as the Commissioner contends, that under the principle of ejusdam generis, the words 'like associations' are limited by the words 'farmers' and 'fruit growers' and as thus limited mean only such associations as market agricultural products, or purchase supplies and equipment for those who are engaged in producing agricultural products. * * *'

"It is therefore held that an association which purchases supplies and equipment for its members who are fishermen is not an association of farmers or fruit growers, or a like association within the meaning of section 521(b)(1) of the Internal Revenue Code of 1954 and is not exempt from Federal income tax under such section.

"The principles states herein relative to the application of section 521 of the 1954 Code to an association which purchases supplies and equipment for its members, who are fishermen, applies equally in case of membership in an association composed of oyster growers."

3. Exemption from tax of a nonprofit agricultural commodity auction. (Rev. Rul. 55-715; I.R.B. 1955-49, 9)

The M organization was incorporated as a nonprofit organization for the purpose of regulating the sale at auction of a specified agricultural commodity in a certain area in order to protect alike the interest of producers, warehousemen and purchasers. To evenly distribute sales among all warehousemen where auctions are held, regulations have been adopted limiting the quantity of products sold and arranging schedules of dates, hours and location of auctions. A trading floor is not maintained. Schedules are so arranged that processing plants will not be overloaded, and so that all crops can be disposed of and yet assure maximum competition at each sale. The organization polices the auctions and enforces its regulations through a supervisor of sales. High standards of the market are maintained by the supervisor, resulting in benefits to the buyers as well as the growers. The organization

furnishes by radio for the benefit of growers technical information on farming of the specified product and during the selling season furnishes market quotations for the previous day. A committee on roads and traffic calls the attention of state officials to growers' needs in bringing their crops to market. Held, the organization qualifies for exemption from Federal income tax under the provisions of section 501(c)(6) of the Internal Revenue Code of 1954 as a board of trade."